No. 16,859

IN THE

United States Court of Appeals

For the Ninth Circuit

HAWAIIAN TRUST COMPANY LIMITED, a Hawaii corporation, Trustee for the Creditors and Stockholders of Pacific Refiners, Limited, a dissolved Hawaii corporation,

Appellant,

vs.

THE UNITED STATES OF AMERICA,

Appellee.

On Appeal from the United States District Court for the District of Hawaii

APPELLANT'S REPLY BRIEF

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APPELLANT'S REPLY BRIEF

FIRST ISSUE: REFINERS WAS ENTITLED TO CARRY FORWARD AS A CONSOLIDATED NET OPERATING LOSS TO 1953 THE NET OPERATING LOSS SUFFERED IN 1950 BY HILO GAS.

A. The applicability of Section 129.

The government asserts that the District Court's conclusion that the primary purpose of the acquisition of Hilo Gas was to evade taxes is supported by substantial evidence. What is that evidence? According to the government's brief, although there was a business purpose justifying the acquisition by Refiners of Hilo Gas, or at least its assets, there was no business purpose to justify the continued existence of Hilo Gas as an affiliate. (Gov. Br. 18-22.) Assuming for the sake of argument that this

is correct,[1] it falls far short of the evidence required to support the District Court's finding.

Section 129 authorizes disallowance of a deduction if a person acquires control of a corporation *"and the principal purpose for which such acquisition was made"* is tax evasion. As noted by the Tax Court in *American Pipe & Steel Corp.*, 25 T. C. 351, 365, 366 (1955), it is the *intent* of the taxpayer, his *state of mind*, which must be determined. Clearly, it is the taxpayer's intent or state of mind at the time the acquisition was made which must be determined, and it is the only thing to be determined.[2] What happens *after* the acquisition is surely immaterial except as illuminating earlier intent in situations where such intent is indistinct or unproved.

In this case it is abundantly clear that *at the time of the acquisition* of control of Hilo Gas, Refiners had no tax evasion purposes whatever. The acquisition of Hilo Gas was for business reasons alone (to obtain the Hilo market for butane and the Rock Gas distribution business on Hawaii), "at the time of the acquisition of the stock

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[1]The record does not show that the continued existence of Hilo Gas as an affiliate of the taxpayer "was admittedly prompted by tax considerations." The only thing in the record on this point is Mr. Dunn's opinion dated November 15, 1950 "pointing out that the loss on the sale to Honolulu Gas would be an allowable deduction in a consolidated return filed by Refiners and Hilo Gas, but that this would not be an immediate benefit because Refiners did not have any net income." (R. 42-43.) There is no evidence that the reason for keeping Hilo Gas alive was for tax purposes. Indeed the only evidence is the stipulation of the reasons for maintaining the corporate existence, which were various possible *business* uses of the corporation. (R. 46.) Hilo Gas was not dissolved after its losses had been used up, as alleged; it continued in existence until 1956 when Refiners itself was dissolved.

[2]The government seems to think that the time for measuring the taxpayer's intent is the time when it files the consolidated tax return, rather than the time of the acquisition. (Gov. Br. 18.) This is indeed to read something into the statute which is not expressly there, contrary to this court's injunction in *C.I.R. v. British Motor Car Distributors, Ltd.*, 278 F.2d 392, 395 (9th Cir. 1960).

* * * no consideration was given by Refiners to the tax aspects of the transaction," Refiners did not even know the book value of the Hilo Gas assets, and it was not until the month *after* the acquisition of control that Refiners considered the tax aspects of the transaction. These facts have been stipulated (R. 27-34, 41-43) and the government does not dispute them (Gov. Br. 20). If Refiners bought control of Hilo Gas for business reasons alone and without considering taxes, as is admitted, how can the subsequent history of Hilo Gas possibly change the taxpayer's intent and purpose in making the acquisition from a business purpose into a tax evasion purpose? It cannot.[3]

The government attributes great significance to the fact that Refiners knew Hilo Gas was in financial difficulty, thereby likening this case to *Elko Realty Co.,* 29 T. C. 1012 (1958), *aff'd* per curiam 260 F.2d 949 (3d Cir. 1958). (Gov. Br. 20.) We think this point is thoroughly disposed of in our opening brief. (Op. Br. 31-37.) Past operating losses of Hilo Gas were of no tax evasion significance unless Refiners attempted to carry them forward, which it did not and could not do. Knowledge that the Hilo Gas manufacturing plant was obsolete likewise would have no tax evasion significance unless Refiners also knew the book value and tax basis for these assets so that it might have planned to sell them at a loss. For

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[3]In all of the cases cited by the government, there have been findings that there was no business purpose for the acquisition or that the tax evasion purpose which was evident at the time of the acquisition was predominant. Thus in *British Motor Car Distributors, supra,* "It is not claimed that there was any business purpose in the acquisition" and "it is clear that the principal purpose of the acquisition * * * by the new owners was to avoid taxes." In *Elko Realty Co.,* 29 T. C. 1012 (1958), the Tax Court found that "no bona fide business purpose was served by the acquisition". (29 T. C. 1018.) In *American Pipe, supra,* Lane knew all about the potential tax benefit *at the time of the acquisition* and there was no reasonable business explanation for the acquisition. These cases have nothing in common with ours.

all that Refiners knew the assets might have been so fully depreciated that the remaining tax basis was less than the market value. However, Refiners did not have this information until *after* the acquisition was completed. Since Refiners already had a substantial loss of its own (almost $100,000) it was not shopping for a tax loss company.

Also the government makes a great point of the "prearranged sale" of the Hilo Gas utility assets to Honolulu Gas, as if this proved the requisite tax evasion intent. (Gov. Br. 14, 19, 21.) We cannot find any tax evasion plot in this. Refiners did not want the utility assets; it was not and did not want to become a regulated utility; indeed it had previously suggested to Hilo Gas a way out of its difficulties which would have eliminated the utility business in Hilo altogether. (R. 27, 31, 34.) On the other hand, there were sound business reasons why Honolulu Gas did not purchase control of Hilo Gas. (R. 34-35.) Quick action was necessary to save the gas business in Hilo. Lyman and Hutchinson offered to sell stock, not assets. (R. 31-34.) Under the circumstances, what was more natural than the course actually taken. When Refiners acquired Hilo Gas it didn't know anything about the book value of the Hilo Gas assets or whether they could be sold at a profit or a loss taxwise; consequently the "pre-arranged" sale to Honolulu Gas was not a tax evasion plan. Further, if anybody had been thinking about tax evasion, Honolulu Gas rather than Refiners should have made the acquisition because Honolulu Gas had profits and could use a tax loss, whereas Refiners could not.

It has long been established that corporate activity is not a prerequisite for continued affiliation. The sole test of what is a member of an affiliated group is statutory, and the only requirement is the requisite stock ownership. Sections 141(a), (d) and (e), I.R.C. 1939; Regs. 129 §§ 24.2(b) and 24.11(c).

> "* * * If conditions necessary to affiliation exist, the status will not be denied merely because one of the affiliated corporations is inactive; there is nothing in the statute which indicates that activity is essential to affiliation." 8 Mertens, *Law of Federal Income Taxation,* § 46.08

The foregoing statement from Mertens is amply supported by the cases, including two decisions of the Supreme Court.

Burnet v. Aluminum Goods Co., 287 U.S. 544 (1933). In 1914 the manufacturing company purchased all the stock of the sales company and the sales company engaged in selling goods manufactured by its parent. In 1917 the sales company was chiefly engaged in closing up its business preparatory to formal dissolution (in February 1918), and *all* of its assets and liabilities were disposed of by the end of 1917 and it did not do any business after that date. In 1917 the two corporations filed a consolidated return for the purpose of the excess profits tax. The Seventh Circuit (56 F.2d 571) held that the liquidation in 1917 ipso facto terminated the affiliation, so that the loss was suffered outside the period of affiliation, stating that "the statute governing affiliated returns contemplated its application to active companies only." The Supreme Court granted certiorari to resolve an alleged conflict between this decision of the Seventh Circuit and decisions of the Court of Claims (*Utica Knitting Co. v. United States,* 68 Ct.Cl. 77, VIII-2 *Cum. Bull.* 352) and the Second Circuit (*Autosales Corp. v. Commissioner, infra*) that activity was *not* a requirement for affiliation. (287 U.S. 546.) Thus the Supreme Court thought it was settling this issue. It held:

> "Since complete stock ownership is made the test of affiliation applicable here under Article 77 of Treasury Regulations 41 and § 1331 of the Revenue Act of 1921, no ground is apparent for saying that the corporations ceased to be affiliated, merely be-

> cause, without change of corporate control, one of them was being liquidated. The findings do not reveal that the liquidation of the Sales Company was completed, that it ceased to do any business or to function as a corporation before the end of 1917. Neither statute nor regulations recognize that affiliation may be terminated by the mere fact that such liquidation is being carried on, * * *." (p. 548)

Ilfeld Co. v. Hernandez, 292 U.S. 62 (1934). In 1929, before the end of November, two subsidiaries sold all their property to outside interests and after paying their debts, paid over the balance to the parent on December 23. Both subsidiaries were dissolved on December 30. The parent made a consolidated return in 1929 and claimed that it was entitled to deduction of the losses resulting to it from the liquidation of the two subsidiaries. The Supreme Court held that the liquidating distributions were *during* a consolidated return period and that the parent could not deduct the loss.

> "* * * The record conclusively shows that each subsidiary handed over the balance before the dissolution was consummated and during the consolidated return period." (p. 66)
>
> "* * * The payment of the liquidating dividends was made during the return period and was the last step leading up to the action of directors and stockholders for the dissolution of the subsidiaries." (p. 67)

Note that in this case the subsidiaries sold *all* of their property before the end of November, paid their debts and made a final distribution to the petitioner on December 23 and were dissolved December 30. The Supreme Court held that the consolidated return period lasted until the dissolution on December 30, despite the fact that the subsidiaries could not possibly have engaged in any business activities after the end of November.

Autosales Corporation v. Commissioner of Int. Rev., 43 F.2d 931 (2d Cir. 1930). A chocolate company owned

all of the stock and controlled all of the property and franchises of a weighing company. The weighing company was not actively engaged in business, all of its machines and franchises being operated by the chocolate company. It was contended by the taxpayer that the two corporations were not affiliated for consolidated return purposes because the weighing company was inactive. The court held to the contrary stating:

> "* * * That the subsidiary is wholly inactive and but a bookkeeping department of the parent company is immaterial, * * *. * * * We are entirely clear that within the taxable years in question the chocolate company and the weighing company were affiliated corporations; a consolidated return was required, * * *." (p. 933)

Hancock Construction Co. et al., 11 B.T.A. 800 (1928) (Acq. VIII-1 *Cum. Bull.* 19). Five corporations were controlled by one individual and were all engaged in the real estate business in 1918, 1919 and 1920 except the Robbins Company, which was inactive during 1920. The Commissioner took the position that the Robbins Company was not affiliated during 1920 with the other companies and that the proportionate part of the net loss for 1919 attributable to it could not be applied against the 1920 consolidated net income. In the latter part of 1919 the Robbins Company turned over its property to a creditor and was left without any assets whatever. The Robbins Company was not dissolved at that time, but merely suspended its activities awaiting a favorable opportunity again to engage in business. The company had no income or expense in 1920 and was without assets of any kind. However, the company was at all times during 1920 under the law able to transact business. The court held that the Commissioner erred in determining that the Robbins Company was not affiliated during 1920, and in refusing to apply against the consolidated net income for 1920 the 1919 loss attributable to Robbins Company.

> "The evidence adduced clearly establishes the fact that during 1920 the Robbins Construction Co. was merely inactive. It had not been dissolved either voluntarily or involuntarily. Its stock was still outstanding, held as above indicated, and it was in a position to transact business. Does the fact that this company was inactive and made no return for 1920 because it had no income or expense preclude it from being a member of an affiliated group of corporations, provided the other requisites of the statute have been met? We think not. * * *
>
> "Section 240(b) of the Revenue Act of 1918, *supra,* does not indicate that activity on the part of a corporation is essential to affiliation. * * *" (p. 804)

Joseph Weidenhoff, Inc., 32 T.C. 1222 (1959). On September 12, 1949 Fostoria Corporation sold all of its assets and terminated its business operations. It was kept in existence until July 31, 1952 when the stockholders adopted a resolution to dissolve and a certificate of dissolution was filed. There were no activities from 1949 to 1952 except nominal activities for the parent. Held, that Fostoria remained a member of the affiliated group until it was formally dissolved.

> "* * * The sole test of what is a member of an affiliated group is statutory; and the only requirement is the requisite stock ownership. * * *" (p. 1233)

The sale of assets, the cessation of operations and the lack of income did not relieve Fostoria of filing a tax return, and if it was required to file a return at all it was required to join in the consolidated returns filed for the affiliated group, which it did.

See also *Bowie Lumber Co., Ltd.,* 20 B.T.A. 342 (1930) *and G. C. M. 2019,* VI-2 *Cum. Bull.* 128.

Certainly, the property, activities and assets of Hilo Gas in 1950 to 1956 were more substantial than those of the inactive corporations in the cases above referred to. During these years it had property, income and expenses,

it filed tax returns and paid taxes, it filed the annual Hawaii Corporation Exhibit, it held meetings of stockholders[4] and directors, for a time it maintained the payroll and provided other services for Refiners and Honolulu Gas[5] in Hilo, it maintained bank accounts, it made *new* leases of property in 1951, 1952 and 1955 and subleased office space to Honolulu Gas and Refiners. At any time during this period it could have been used as a financing vehicle or as an Isle-Gas distributor, as was under consideration. It was not formally dissolved until September 18, 1956. (R. 41-46.) The activities of Hilo Gas went beyond transactions carried on for the single purpose of liquidation of assets and consequently the corporation was still doing business. See *Willis v. Commissioner of Internal Revenue,* 58 F.2d 121, 123 (9th Cir. 1932).

Regs. 118 § 39.52-1 states:

> "A corporation is not in existence after it ceases business and dissolves, retaining no assets, whether or not under state law it may thereafter be treated as continuing, * * *."

Rev. Rul. 56-483, 1956-39 I.R.B. 15 rules that a corporation which had ceased all business operations and had no further sources of income but had retained a small sum of cash for the stated purpose of paying annual state taxes to preserve the corporate charter was required to file a Federal income tax return. This court has held that simply because a corporation has ceased all operations does not mean that it has ceased business and dissolved under this regulation. *Berry v. Commissioner of Internal Revenue,* 254 F.2d 471 (9th Cir. 1957). If Hilo Gas was sufficiently active to be a "corporation" under Section 52 so as to be required to file income tax returns, it must

[4]Hilo Gas never became a wholly-owned subsidiary of Refiners. (R. 35.)

[5]Honolulu Gas was not an affiliate of Hilo Gas, although it had some of the same stockholders as Refiners. (R. 25-26.)

similarly be a "corporation" under Section 141 and as such continued as a member of an affiliated group.

B. Denial of the loss carry forward for reasons apart from Section 129.

Apart from Section 129 other arguments are advanced by the government to deny the privilege to which the taxpayer is entitled under Section 141. We submit that these arguments and the principles and authorities cited are inapplicable to this factual situation and may readily be disposed of.

First, it is said that the utilization of the consolidated return privilege here would be to "distort" income, relying on *Spreckels, David's Shops* and distinguishing *Bishop Trust.* (Gov. Br. 22.) As noted in our opening brief, if the loss of the subsidiary is realized *after* affiliation[6] it not only may, it must, be included in the consolidated return under Section 141 and the Regulations and if there is any distortion it is one deliberately provided by Congress and the Treasury. (Op. Br. 52-55.) *Spreckels* is not on "all fours," as it is simply a case where there was no business reason at all for the acquisition, only a tax reason. At the time of the acquisition the stock of the subsidiary had no value. No business reason for the acquisition was ever claimed by the taxpayer. (Op. Br. 55-58.) *David's Shops* is another case where there was found to be no business reason for the acquisition, but if there is a business reason the court said the tax benefit from filing consolidated returns cannot be denied even though the stock of the subsidiary cost the parent nothing. (Op. Br. 60-61.) Actually, *Bishop Trust* is closer to this case than any other. The Commissioner contended that Waterhouse Trust was hopelessly insolvent when acquired, that it was held only

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[6]The facts here are that the period of affiliation commenced *prior* to October 25, 1950 and the subsidiary's loss could not and did not occur until October 31, 1950. (R. 35-37.)

for the purpose of liquidation, and therefore that it could not be an affiliate of Bishop Trust. (36 B.T.A. p. 1179.) The Commissioner's contentions there are strikingly similar to the government's contentions here. The Board held that the acquisition was for a *bona fide* business reason, and that the Commissioner's determination denying affiliation was error.

The government's next point is that the Commissioner could have allocated the loss solely to Hilo Gas under Section 141(b) or Section 141(i) and Section 45. Section 141(b) merely directs the Secretary to prescribe regulations in order that the tax liability of an affiliated group and its members may clearly reflect income. Acting under this, the Secretary has prescribed the Consolidated Return Regulations which taxpayer here admittedly has complied with and under which a post-affiliation loss of a subsidiary is to be used against the parent's profits. (Op. Br. 18-23, 52-55.) Section 141(i) says that for allocation of income and deductions of *related* trades or businesses see Section 45. This must mean entities which are *related* but either are not *affiliates* under the statutory test or have not chosen to file consolidated returns. There is no room left for more allocation under Section 45 if consolidated returns are filed, as all allocation problems are comprehensively dealt with in the Consolidated Return Regulations themselves.[7] Regs. 118 § 39.45-1(b)(2) provide that if a controlled taxpayer is a party to a consolidated return, the true consolidated net income of the affiliated group is *determined consistently with the principles of a consolidated return.* The Regulations also announce that the purpose of Section 45 is to place a controlled taxpayer on a parity with an uncontrolled taxpayer. Regs. 118 § 39.45-1 (b)(1). There is no evidence here to support any conclu-

[7]*National Securities Corp. v. Com'r of Internal Revenue*, 137 F.2d 600 (3d Cir. 1943), has nothing to do with consolidated returns, none having been filed in that case.

sion that the dealings between Refiners and Hilo Gas were not fair and that the same transactions would not have been undertaken if the corporations had been independent. No valid reason exists for a reallocation under Section 45 except to prevent Refiners from securing the benefit of the net operating loss carryover. See *Virginia Metal Products, Inc.,* 33 T. C. .... No. 88 (1960). We do not see how the Commissioner could have exercised his authority to allocate in this case. The government proposes to allocate the deduction solely to Hilo Gas, but this is no change from what the taxpayers did. The loss was reported as a Hilo Gas loss, not a Refiners loss. Further, even if the Commissioner had authority to allocate the loss to Hilo Gas under Section 45 on the ground of tax evasion or "clearly to reflect income," he never did so. (R. 47.) It is too late for the government to attempt to do so now. *Chelsea Products, Inc.,* 16 T. C. 840 (1951), *aff'd* in part 197 F.2d 620, 624 (3rd Cir. 1952); *Wilfred J. Funk,* 3 CCH *Tax Ct. Mem.* 100, 103 (1944); *Ross v. Commissioner of Internal Revenue,* 129 F.2d 310 (5th Cir. 1942).

The next suggestion is that Refiners was not the corporate entity that suffered the loss and therefore cannot claim it. (Gov. Br. 23-24.) This cannot be the rule in the case of consolidated returns as it is everywhere recognized that a principal advantage of consolidated returns is that losses of loss members of the affiliated group may be used to offset the income of *other* members of the group. Peel, *Consolidated Tax Returns* § 2.02 (Callaghan & Co. 1959). See also Opening Brief pp. 51-52. In fact, in the leading case cited by the government to support this proposition, *Lisbon Shops, Inc. v. Koehler,* 353 U.S. 382 (1956), the Supreme Court expressly recognized that if the corporations involved had chosen to file a consolidated return they could have taken the losses of three members of the group against the consolidated net income of the group as a whole, *"an opportunity that they elected to forego when*

they chose not to file a consolidated return." (p. 388) (Emphasis added.) None of the other cases cited by the government involve consolidated returns and are not in point. The maintenance of a period of affiliation during which a loss occurred was not "unreal or a mere sham" as the government suggests. Hilo Gas was an old established utility. It could not dispose of its utility assets without PUC approval. The PUC's order granting approval necessarily recognizes the separate corporate identity of Hilo Gas. (R. 53.) There was surely nothing unreal or sham about the transaction establishing the Hilo Gas loss or about its corporate entity. *Cf. Kraft Foods Company v. Commissioner of Internal Rev.,* 232 F.2d 118, 124 (2d Cir. 1956).

Finally, the government urges the applicability of the *Kimbell-Diamond* rule. (Gov. Br. 24-26.) This is going far afield. The rule is that where stock of a corporation is purchased in order to get physical assets and the purchaser then promptly liquidates the corporation and receives the assets, the separate steps will be treated as a single transaction—the purchase of property—and the purchaser's basis for the assets will be his cost of the stock. If the purchaser of the stock never receives the assets, there can be no question of his purchasing property and no basis question and thus no occasion for the operation of the rule. For example, the rule as codified in Section 334(b)(2), I.R.C. 1954, is not applicable except where property is received by a corporation in a distribution in complete liquidation of another corporation. In *United States v. Mattison,* 273 F.2d 13 (9th Cir. 1959) principally relied on by the government, Mattison wanted the operating assets of Wescott Oil Co. so he could sell them to Continental Oil Co. He bought all the stock of Wescott and promptly had the company liquidated and dissolved, transferring all its assets to him. He then immediately sold the operating assets to Continental. Since

he received assets on the liquidation, there is a situation where the rule can operate. This court held:

> "* * * The Kimbell-Diamond rule is not to be applied *unless the purpose of the transaction was to acquire the assets* of the company whose stock has been purchased. * * * Where the objective is to consummate a pre-arranged sale of the assets, the purpose to acquire is just as certainly established as where the objective is to integrate the assets into the business. In both cases *the title to the assets must be obtained* before the objective can be realized. * * *" (273 F.2d 19) (Emphasis added.)

The factual situation in the present case simply does not permit application of the *Kimbell-Diamond* rule. Refiners never acquired the utility assets of Hilo Gas; it never obtained title to these assets and never intended to. If it had acquird the Hilo Gas utility assets it would have become a regulated public utility, a situation it wanted to avoid. (R. 27-28.) Refiners' purpose was to secure a market for butane on the Island of Hawaii. It was interested in the business and customers of Hilo Gas, not its physical assets. (R. 29-34.) In fact, one of its proposals was that the Hilo Gas utility plant be scrapped altogether and gas appliances hooked up to butane tanks. (R. 31.) The appliance and liquefied petroleum gas assets which Refiners acquired from Hilo Gas were a relatively small proportion of its total assets. (R. 37-38.) Hilo Gas was not liquidated promptly, and when liquidated in 1956, the assets distributed to Refiners were not physical assets but intangibles. Hilo Gas sold its utility assets to Honolulu Gas and that company scrapped much of the Hilo Gas manufacturing plant after the conversion of the distribution system to butane air. (R. 38-39.)

Refiners could not possibly meet the two tests for the *Kimbell-Diamond* rule laid down by *Mattison*—the *purpose* of the transaction was not to acquire the physical assets of Hilo Gas and *title* to such assets was not ob-

tained by Refiners. Refiners has no *basis* problem, as suggested by the government. It never acquired the utility assets, so it can have no basis for them. Only the basis of Hilo Gas for the assets is significant, and there is no question raised about that. The loss on sale of the assets was a real loss suffered by Hilo Gas as a separate corporate entity. Hilo Gas is entitled to a deduction for this loss under Section 23(f) and Regs. 118 § 39.23(f), and Refiners is entitled to include this loss in its consolidated return.

SECOND ISSUE: HAWAII INCOME TAXES ON CAPITAL GAINS REALIZED IN 1955 ARE DEDUCTIBLE.

A. Section 265 is not applicable because non-recognized gains under Section 337 are not income "wholly exempt" from the income tax.

The government meets this point by relying on the technical argument that the corporation itself will never pay a tax on these gains, since it is to be dissolved and its existence terminated.

However, the government does not deny that the same gains will be taxed to the stockholders of the liquidated corporation—and within one year of the adoption of the plan of liquidation—if Section 337 is complied with. The fact that under Section 337 there is a tax on the *same gains* to the stockholders is amply demonstrated by the Committee Reports quoted in our opening brief. (Op. Br. 71-74.)[8]

The Internal Revenue Service has recognized that gain under Section 337 is not wholly exempt. Rev. Rul. 56-387, 1956-2 *Cum. Bull.* 189, deals with the liquidation of an

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[8]For example, the House Report states:

"* * * your committee has provided that if a corporation in process of liquidation sells assets there will be no tax at the corporate level, *but any gain realized will be taxed to the distributee-shareholder,* * * *." (Emphasis added.) H.Rep. 1337, 83d Cong., 2d Sess., 1954, pp. 38-39.

insolvent corporation. It was planned to liquidate the corporation within a twelve-month period and distribute the assets to the creditors. The Ruling held that Section 337 could not be applicable to the gain on the proposed sale since all the assets would be distributed to creditors and none to the stockholders.

> "* * * Congress intended through section 337 of the 1954 Code *to eliminate the double tax on gains realized from sales of corporate assets* during a period of liquidation, *but did not intend to eliminate entirely the tax on such gains.* Where the shareholders are to receive nothing in the liquidation in payment for their stock, there is no possibility of a tax to both the corporation and the shareholders *on the gains resulting from the sale.*" (Emphasis added.)

The fact that the gain to the stockholders may be measured by a different basis than the gain to the corporation is of no significance. The gain realized when a liquidating corporation sells assets at a profit is promptly passed on to the stockholders and becomes part of the gain which they realize and are taxed upon when they surrender their shares for redemption. The same gain is taxed to the stockholders as would be taxed to the corporation if Section 337 did not intervene, a result intended by Congress and stressed by the Internal Revenue Service in Rev. Rul. 56-387. Hence, it cannot be said that such gain is income "wholly exempt" from taxation.

The government reads Section 265 as if it referred to income "wholly exempt *to the taxpayer* from the taxes imposed by this subtitle." However, the words "to the taxpayer" are not present. In fact, the legislative history shows that the words "to the taxpayer" were first inserted and then eliminated from the section. The section involved is Section 24(a)(5), the predecessor of Section 265(1). As originally reported by the House Ways and Means Committee the section provided:

> "Any amount otherwise allowable as a deduction which is allocable to one or more classes of income

> * * * wholly exempt *to the taxpayer* from the taxes imposed by this subtitle."

The words "to the taxpayer" were eliminated from the Ways and Means Committee bill by the Senate Finance Committee. The Conference Report with respect to this change states:

> "The House bill disallowed deductions allocable to income 'wholly exempt to the taxpayer' from the taxes imposed by title I. The Senate amendment makes the disallowance of the deduction depend on whether the income is 'wholly exempt' from the taxes imposed by title I. The House recedes." Seidman's, *Legislative History of Federal Income Tax Laws, 1938-1861,* p. 315.

By eliminating the words "to the taxpayer" Congress can only have intended to make the test whether the income is *wholly exempt* from taxes, not whether it is exempt to one particular taxpayer. In other words, if it is exempt to one taxpayer but taxable to another, the test is not satisfied. This is the situation, in a nutshell, in a Section 337 liquidation.

Cotton States Fertilizer Co., 28 T. C. 1169 (1957), *acq.* 1958-1 *Cum. Bull.* 4, makes two points: first, that non-recognized gains are not the kind of exempt income covered by Section 24(a)(5), and second, that because of the required basis adjustment the taxpayer corporation will have to pay the tax in a subsequent year *if* it sells the property at a profit. The first point is made twice, once at p. 1172 where the court says that Sections 22(b) and 116 list a great number of items which are exempt from tax and that fire insurance proceeds which are not recognized under Section 112(f) are not listed as being exempt, and once at p. 1173 where the court distinguishes cases cited by the Commissioner because they involved life insurance proceeds made wholly exempt by statute. The Tax Court is clearly of the opinion that there are three

classes of income—taxable income, exempt income and non-recognized income, and that the latter is not included under Section 24(a)(5). This first point made by the Tax Court is directly applicable here because the gain is a non-recognized gain under Section 337, not an exempt item under Section 22(b) or Section 116. With respect to the second point, the only significant difference between the involuntary conversion situation and the Section 337 liquidation situation is that in the former case the tax is indefinitely postponed (until such time as the taxpayer may sell the property at a profit), whereas in the latter case the tax on the same gain may be postponed for not more than one year and must then be paid by the corporation's stockholders. The tax on the gain is not eliminated, only the *double tax* is avoided. In view of the express recognition in the Congressional Committee Reports and in Rev. Rul. 56-387, *supra,* that Section 337 did not eliminate entirely the tax on the gains realized in a corporate liquidation, the government's attempt to distinguish *Cotton States* on the ground that the tax in a Section 337 liquidation is "wholly relieved" must fail.

The government misunderstands the reason for the citation of the cases on liquidation expenses referred to in our opening brief (Op. Br. 76). These cases are cited to show that liquidation expenses, including taxes, are allowed as deductions in a liquidation procedure utilizing the *Cumberland Public Service* route. However, under the government's argument, these liquidation expenses would *not* be allowable in a Section 337 liquidation because they would be connected with production of tax exempt income. Our point is that this is a result which Congress could not have intended because it enacted Section 337 for the specific purpose of removing the distinction between the *Court Holding Company* and *Cumberland Public Service* liquidation routes. Consequently, Congress cannot have intended to have Section 265 applied to non-recognized gains under Section 337.

B. Section 265 is not applicable because it does not reach the Hawaii income tax which is fully deductible under Section 164.

We do not suggest, as the government implies (Gov. Br. 28-29) that Section 265 is more limited than Section 24(a)(5) because of the new section heading, "Expenses." We suggest only that in the 1954 re-write of the Code Congress expressed its *original* intention with respect to the scope of this section by utilizing the heading "Expenses." Section 24(a)(5) had no heading; when the time came to give the section a heading, Congress chose an accurate one: "Expenses and Interest Relating to Tax Exempt Income." Moreover, the limitation of Section 265 to expenses is the only interpretation which is consistent with the legislative history of Section 24(a)(5). (Op. Br. 80-81.) The Committee Reports are specific to the effect that Congress intended to eliminate as deductions from gross income *expenses incurred in the production of such income.* A state income tax on the profit derived from a sale cannot be an expense incurred in the production of the income realized on the sale. Commissions, fees and other selling expenses actually have a part in producing the income itself, whereas income taxes, levied after the sale has been completed on the taxpayer's net income for the entire year, can have no part in producing the tax exempt income.

Another reason why Section 265 is not applicable is that state income taxes are not properly "allocable" to the gain realized in a Section 337 liquidation.[9] As pointed out in our opening brief (Op. Br. 84) state income taxes are not applicable to reduce gain on the sale of assets, but are an absolute independent deduction under Section

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[9]Section 265 refers to any amount otherwise allowable as a deduction which is *allocable* to a class of exempt income. The Commissioner has allocated $61,061 of the Hawaii income tax to the gain from the sale of assets (R. 51) and there is no quarrel with his mathematics. However, we submit that, as a matter of law, the Hawaii tax is not a deduction which is properly "allocable" to the gain within the meaning of Section 265. *Cf. Carstairs v. United States,* 75 F.Supp. 683, 685 (E.D. Pa. 1936).

164. Section 337 provides for non-recognition of "gain" from the sale of property. "Gain" is determined under Section 1001, and it is there provided that gain is the excess of the amount realized from the sale over the adjusted basis. Adjusted basis is determined under Section 1016, and under this section it is clear that income taxes are not a deduction to be made in computing adjusted basis. See Regs. 1.1016-2(c), last sentence. Since the gain which is the subject of Section 337 is computed entirely without reference to the state income tax, the state tax cannot be "allocable" to the gain within the meaning of Section 265. Allocating the state tax to the gain after it has been computed under Sections 1001 and 1016 has the effect of recomputing the gain in a manner forbidden by the statute.[10] State income taxes have no relationship to the production of income or the obtaining of a capital gain but are tax exactions for the support of the state government levied on the results of all transactions which occur during a fiscal period, after such period has terminated.

Consequently, a state income tax is not within the scope of Section 265 because it is not an expense incurred in the production of income and because it is not properly allocable to the gain from the sale of property.

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October 31, 1960.

Respectfully submitted,
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[10]It has never been held that state income taxes are allocable to a capital gain realized on the sale of property. The cases cited by the government on allocation of state taxes to exempt income (Gov. Br. 28) are not in point here because they relate to income taxes on exempt compensation, not to gains from the sale of property.